

# EMPLOYEE BENEFITS DEVELOPMENTS

  
**Hodgson Russ**  
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February 10, 2003 to February 21, 2003

## IRS/DOL Rulings, Opinions, Etc.

**JCT's Enron Report Recommends Deferred Compensation Rule Changes.** On February 13 the Joint Committee on Taxation (JCT) published a three-volume report that concludes Enron used various tax and accounting techniques to avoid approximately \$2 billion in federal taxes. The report also evaluates Enron's pension and executive compensation arrangements and offers troublesome assessments of the current state of the law. The report suggests granting executives too much control over their deferred compensation (e.g., the ability to elect between investment options or the ability to make second elections as to the timing and form of payouts), as was done in the Enron case, could result in immediate taxation. The report recommends a number of changes to the deferred compensation rules that, if adopted, would dramatically alter how deferred compensation arrangements are structured and taxed. For example, the report recommends rules be developed to require current income inclusion where plan features give executives control over aspects of their deferred compensation such as participant-directed investments or the ability to make second elections regarding form and time of payments. The report also recommends consideration of more stringent rules governing rabbi trust arrangements and more extensive reporting requirements for deferred compensation arrangements. The fall-out from Enron clearly is not over. We will monitor and alert you to further developments. (<http://www.house.gov/jct/>.)

**HIPAA Security Standards Finalized and EDI/Code Set Standards Modified.** On February 13 the Department of Health and Human Services issued final HIPAA standards governing the security of electronic protected health information and also released modifications to the final HIPAA electronic data interchange (EDI) and code set standards. Covered entities must generally comply with the final security standards by April 21, 2005 (April 21, 2006 for small health plans) and with the modified EDI and code set standards by October 16, 2003. 68 Fed. Reg. 8334 (Feb. 20, 2003) (final security standards); 68 Fed. Reg. 8381 (Feb. 20, 2003) (EDI and code set standards modifications).

**DOL to Make It "Easier" for Plans to Avoid Prohibited Transaction in Settling Claims.** The Department of Labor is proposing a prohibited transaction class exemption (PTCE) that will make it "easier" for plan fiduciaries to settle litigation disputes involving a pension plan and a party in interest. A settlement payment by a party in interest to a plan could be construed as a prohibited transaction (e.g., a prohibited sale or exchange of property or an impermissible extension of credit). The proposed PTCE would exempt, subject to certain conditions, plan releases of legal or equitable claims in exchange for payment of settlement amounts by a party in interest, including payment of the settlement amounts in installments. If this PTCE is issued, plans wishing to settle disputes with parties in interest (e.g., class action securities fraud cases in which the

plan is a member of the plaintiff's class) presumably would be relieved of some concerns that the settlement of the dispute might itself result in a prohibited transaction. Not all practitioners, however, are applauding this proposed PTCE. Conditions such as requiring the settlement to be negotiated by an "independent" fiduciary and requiring the settlement to be in the "best interest" of the participants and beneficiaries are viewed by many as being impractical and potentially expensive to fulfill. 68 Fed. Reg. 6953 (Feb. 11, 2003).

**Overdraft Protection on Plan Accounts Can Be Exempt From Prohibited Transaction Rules.** The Employee Benefits Security Administration (EBSA) published an Advisory Opinion in which it advised a bank providing custodial or trust services and offering overdraft protection services in connection with the settlement of securities and other financial market transactions is not necessarily engaged in a prohibited transaction. While the bank is a party in interest and overdraft protection services are an inherent extension of credit to the plan, EBSA determined those services "appear to be necessary to ensure the orderly processing" of financial transactions, and are therefore covered by a statutory exemption that allows a party in interest to provide necessary services to the extent those services are provided in accordance with a reasonable contract or arrangement and no more than reasonable compensation is paid for those services. The Advisory Opinion also concludes that overdraft protection services can be ancillary services provided by a federally- or state-supervised bank or similar financial institution for which there is another statutory exemption available. The EBSA ultimately would not rule whether the overdraft protection services are entitled to the "ancillary services" statutory exemption because the ruling requires a factual determination that the EBSA will not make. (EBSA Adv. Op. 2003-02A.)

**ESOP May Direct Certain Rollovers of S Corporation Stock to an IRA.** As long as certain conditions are satisfied, Treasury and the Internal Revenue Service (IRS) have determined that it is consistent with the purposes of, and policies underlying, employee stock ownership plans (ESOPs) to enable an ESOP to direct certain rollovers of distributions of S corporation stock to an individual retirement plan (IRA) in accordance with a distributee's election without terminating the corporation's S election. (Revenue Procedure 2003-23.)

**IRS Clarifies Basis Adjustment Rules for ESOPs Holding S Corporation Stock.** The IRS ruled an ESOP is required to adjust its basis in S corporation stock under Internal Revenue Code (Code) § 1367(a) for the ESOP's pro rata share of the corporation's income. When the S corporation stock is distributed by an ESOP to a participant, the stock's net unrealized appreciation under Code § 402(e)(4) is determined using the ESOP's adjusted basis in the stock. (Revenue Ruling 2003-27.)

## Cases

### Plan Benefit Accruals Must Account for Pre-ERISA Years of Service.

In a decision that conflicts with our notions of “well-settled law,” the Second Circuit Court of Appeals ruled a plan sponsor may not apply pre-ERISA break-in-service rules to exclude pre-ERISA years of benefit accrual. When James McDonald retired in 1991, having worked as a longshoreman for almost 40 years, he brought suit against the New York Shipping Association International Longshoremen’s Association Pension Trust Fund and its trustees, contending that his pension calculations didn’t reflect 13 years during which he had accrued benefits before incurring a break in service in 1969. At issue was a plan provision that permitted the trustees to disregard years of service worked prior to a break in service occurring before the passage of ERISA. The District Court required the trustees to remove the break-in-service provision retroactively to January 1, 1976, ERISA’s effective date, and the trustees appealed. The Second Circuit agreed with the District Court, holding that an ERISA provision requiring benefit accruals to account for all of a participant’s years of service trumped the plan’s break-in-service provision that limited the accrual of benefits arising from pre-ERISA employment. A different ERISA provision that permitted plans to exclude, for vesting purposes, years of service that would have been disregarded under a pre-ERISA plan’s break-in-service rules was deemed inapplicable in determining the accrued benefit payable to an employee like Mr. McDonald who has satisfied the vesting requirements. Sponsors of defined benefit plans should review their plan documents to determine what impact, if any, the court’s decision may have on retiree benefits. (*McDonald v. Pension Plan of NYSA-ILA Pension Trust Fund*, \_\_\_ F.3d \_\_\_, 2003 WL 262231 (2d Cir. 2003).)

### ERISA Does Not Preempt Medical Malpractice Claim Against HMO.

At any given time, it’s difficult to know where ERISA preemption ends and the states’ traditional role in the regulation of health care begins. Witness the latest case in point. Carmine Cicio developed multiple myeloma, a prevalent form of blood cancer, and his HMO, Vytra Healthcare, denied a pre-approval claim for the treatment method espoused by his treating oncologist in favor of a different methodology. Mr. Cicio died and his widow Bonnie sued Vytra and its medical director in state court under a number of theories, including medical malpractice. Defendants removed the case to federal court, where it was dismissed on preemption grounds. Mrs. Cicio appealed. In a question of first impression in the Second Circuit, the Court of Appeals ruled ERISA does not preempt Mrs. Cicio’s state law medical malpractice claim based on Vytra’s medical

decision made in the course of a prospective utilization review. (*Cicio v. Does*, \_\_\_ F.3d \_\_\_, 2003 WL 283150 (2d Cir. 2003).)

**Officer Liable for Benefit Contributions, Other Payments Under CBA.** Juan Lorenzo probably wishes he had carefully read through his company’s collective bargaining agreement (the Agreement) with the Mason Tenders District Council (the Union) before he signed on the dotted line. Mr. Lorenzo was co-owner and president of Asturias, Inc., and in that capacity, he had the authority on the company’s behalf to remit monetary contributions to the Union’s welfare fund and make other payments required under the Agreement. But Mr. Lorenzo also separately signed a provision that required him “to be personally bound by and to assume all obligations of the Employer provided in this Agreement.” The District Court for the Southern District of New York held, with a stroke of the pen, Mr. Lorenzo himself became a party to the Agreement and was personally liable, jointly and severally with Asturias, for any unpaid obligations. (*Mason Tenders Dist. Council Welfare Fund v. Asturias, Inc.*, Slip Copy, 2003 WL 179770 (S.D.N.Y. 2003).)

### Continued Use of Expired Policy Resulted in Current Right to Severance.

As we’ve counseled our clients time and again, inconsistent severance practices can be costly. AcoustiSeal filed for bankruptcy protection seeking to reorganize under Chapter 11 and shortly thereafter terminated 13 employees. The bankruptcy case was then converted to a Chapter 7 liquidation, and the terminated employees sought severance pay in accordance with AcoustiSeal’s alleged severance policy and practice. The Bankruptcy Court ruled that, while AcoustiSeal did not currently maintain a written severance policy, the company’s failure to advise of the expiration of a previous written policy, together with its continued practice and custom of paying severance packages even after that previous policy expired, amounted to an enforceable policy upon which the terminated employees relied to their detriment and under which they were now entitled to severance pay. (*In re AcoustiSeal, Inc.*, \_\_\_ B.R. \_\_\_, 2003 WL 355976 (Bankr.W.D.Mo. 2003).)



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### Employee Benefits

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